THE WELFARE-TO-WORK TAX CREDIT

A JOINT ECONOMIC COMMITTEE REPORT

Jim Saxton (R-NJ)
Chairman

Joint Economic Committee
United States Congress

March 1997

Executive Summary

The Administration has proposed a Welfare-to-Work Tax Credit aimed at providing job opportunities for long-term welfare recipients. Several studies have shown that an earlier version of the plan which used tax credits to subsidize wages of target groups was not an effective or economical way of helping target group members obtain jobs. It is unlikely that the proposed differences between the Welfare-to-Work Tax Credit and its predecessor will effectively address the shortcomings of the earlier plan. Furthermore, the proposed plan may create other problems and inefficiencies which are common to targeted tax credits of its kind.

Joint Economic Committee
G-01 Dirksen Building
Washington, DC 20510
Phone: 202-224-5171
Fax: 202-224-0240

Internet Address:
http://www.house.gov/jec/

M.C.
INSIDE MAIL

The Welfare-to-Work Tax Credit

The challenge of moving welfare recipients from the welfare rolls to the payrolls is not new; and using tax credits to subsidize the wages of hard-to-employ individuals, such as welfare recipients, has been a familiar response to the challenge for over 20 years. Businesses that hire welfare recipients face the potential risk that the individuals may be less productive or less skilled than other employees. It is hoped that wage subsidies will compensate employers for this risk, while providing welfare recipients the opportunity to develop the skills and experience necessary to secure long-term, unsubsidized jobs.

In the latest effort to move individuals from welfare to work, President Clinton has proposed the Welfare-to-Work Tax Credit (WWTC), which is similar to an earlier program called the Targeted Jobs Tax Credit (TJTC). An audit of the TJTC program, conducted by the Inspector General (IG) of the U.S. Department of Labor, concluded that the TJTC was "not an effective or economical means of helping target group members obtain jobs."[1]

The Administration claims that the WWTC was designed with criticism of the old plan in mind, but it is doubtful that the proposed changes will effectively address the problems which riddled the TJTC program. In particular, it is not clear that the WWTC will provide greater incentives for employers to change their hiring decisions. Furthermore, the WWTC may create other problems and economic inefficiencies which are common to narrowly targeted tax credits.

The Programs and Proposals

Targeted Jobs Tax Credit

The TJTC program was enacted in 1978 to help provide job opportunities for specific groups which normally experience high unemployment rates.[2] The program permitted businesses to claim a tax credit if they hired eligible members from the target groups. Employers could claim 40 percent of the first $6,000 of wages paid during the first year of employment (for a maximum credit of $2,400 per worker), provided the worker was employed for at least 90 days, or 120 hours.[3,4] The firm's wage deduction for tax liability had to be reduced dollar for dollar by the amount of the credit.

[1] Office of Inspector General, U.S. Department of Labor, *Targeted Jobs Tax Credit Program: Employment Inducement or Employer Windfall?,* August 1994.

[2] The TJTC replaced the New Jobs Tax Credit which was not focused on chronically unemployed target groups.

[3] For summer youth employment, the tax credit was equal to 40 percent of the first $3,000 of wages, and the minimum employment period was 14 days, or 20 hours. Initially, it had been 85 percent of the first $3,000 of wages earned.

[4] The amount of the credit was reduced over time. When TJTC was originally enacted, the credit equaled 50 percent of the first $6,000 of wages in the first year, and 25 percent of the first $6,000 of wages in the second year. The minimum retention period was added in 1986 with the passage of the Tax Reform Act of 1986.

The targeted population included persons with disabilities referred from state or Department of Veteran Affairs vocational rehabilitation; economically disadvantaged youth (including cooperative education students), summer youth, Vietnam-era veterans, and ex-felons; and recipients of Supplemental Security Income (SSI), General Assistance, or Aid to Families with Dependent Children (AFDC). The Lower Living Standard Income Level (LLSIL) was used to determine whether individuals were "economically disadvantaged."

Since its inception, TJTC was amended almost a dozen times in attempt to correct several of the program's shortcomings. The tax credit expired on December 31, 1994.

Work Opportunity Tax Credit

The Work Opportunity Tax Credit (WOTC), implemented on October 1, 1996, replaced the TJTC program. Under WOTC, the tax credit was lowered to 35 percent of the first $6,000 of wages (for a maximum credit of $2,100 per worker), and the minimum retention period was extended to 180 days, or 400 hours.[5] Like the TJTC, wage deductions must be reduced by the amount of the credit.

The groups targeted under WOTC were slightly modified from the earlier program. Recipients of SSI benefits or General Assistance were excluded from the target list, while certain recipients of food stamps were added.[6] The minimum time period of required AFDC/welfare assistance was extended from at least 90 continuous days under TJTC to nine months under WOTC; and eligibility was extended to some family members of welfare recipients. Finally, qualified youth must reside in empowerment zones or enterprise communities instead of qualifying under LLSIL guidelines.

WOTC is due to expire on September 30, 1997, but the proposed budget seeks to extend the credit for an additional year.

Welfare-to-Work Tax Credit

The proposed WWTC would amend the WOTC program by adding long-term welfare recipients to the list of target groups. The tax credit would cost $287 million, between 1998-2002, to be wholly financed through the elimination of purported corporate subsidies.[7] Employers could claim a 50-percent credit on the first $10,000 of wages paid to qualified welfare recipients for the first two years of employment. Thus, the maximum credit per worker is $5,000 per year for two years. Qualified wages would include the employer's cost of educational assistance, health care and dependent care.

---

[5] For summer youth employment, the tax credit is equal to 35 percent of the first $3,000 of wages, and the minimum employment period is 20 days, or 120 hours.

[6] The proposed budget seeks to expand the group of qualified food stamp recipients.

[7] This figure is the Office of Management Budget's estimate of lost revenue only. It does not include appropriations for administrative costs.

The targeted group would include: 1) members of families that have received assistance from AFDC (or successor programs) for at least 18 consecutive months ending on the hiring date; 2) members of families who have received a total of 18 months of family assistance (consecutive or not) after the date of the credit's enactment, provided they are hired within two years of the date that the 18-month total is reached, and 3) members of families who are no longer eligible for family assistance because of Federal or state-time limits, as long as they are hired within two years of the date they became ineligible for family assistance.

Review of the Inspector General's Audit[8]

The economic efficiency and social benefits of the WWTC can be assessed by analyzing the TJTC on which it was based. A comprehensive audit of the TJTC program was conducted by the Office of Inspector General at the Labor Department to determine whether the program was an effective, economical means of providing employment for target group members. The review covered the program's activities between July 1, 1991 through June 30, 1992 (Program Year 1991). The IG concluded that the program had virtually no impact on inducing employers to hire members of the target group and recommended the program be discontinued after its expiration.

- **Would employers have hired the applicants without a tax credit?**

  Based on interviews with employers and job applicants, it was estimated that, nationally, 92 percent of the employees hired under TJTC would have been hired even if the tax credit was not available. In most cases, employers did not change their hiring practices to actively recruit members of TJTC target groups. Instead, they determined which new hires coincidentally fit TJTC eligibility. Of the employers surveyed, 86 percent determined TJTC eligibility *after* a job offer was made. The audit report states, "Our findings indicate that most of the individuals certified for TJTC would have been hired even without the incentive. Consequently, the program is a windfall for employers who hire participants they would have employed in the absence of TJTC."

- **What did the TJTC program cost, and what were its benefits during the audit p eriod?**

  During Program Year 1991, it was estimated that the program cost about $374 million in administrative costs and tax credits, but generated wage benefits of only $140 million to employees who would not have been hired without the program. In other words, costs exceeded benefits by approximately $234 million, so that the program lost 63 cents for each dollar of total costs.

[8] *Op. Cit., Targeted Jobs Tax Credit Program: Employment Inducement or Employer Windfall?,* p. 16 - 32

♦ **What impact did the program have upon target group members?**

Auditors assessed the impact of the program on the TJTC participants to determine whether the program helped improve their standard of living and long-term job prospects. The study compared information on individuals' TJTC jobs with jobs they held before and after their TJTC employment. The results are outlined below.

1) On average, the program did not improve individuals' earnings, although small gains did occur for those who obtained work after their TJTC employment. The average annual earnings for TJTC employees were $7,738, only $928 above the poverty level guidelines for a family of one. Thirty-seven percent of the workers sampled were paid at or below minimum wage. The table below shows that the average starting salary of TJTC jobs was $4.96, an amount less than the average earned in previous or subsequent jobs. Although earnings increased slightly in jobs held after TJTC employment, the increase is thought to be more related to the general transition to the workforce than to participation in the TJTC program.[9]

TJTC Employment Does Not Substantially Improve Participants' Earnings or Hours Worked

	Prior to TJTC	Starting TJTC	Ending TJTC	After TJTC
Average Wage	$5.22	$4.96	$5.36	$5.52
Average Hours/Week	32	30	31	34

Source: Office of Inspector General, U.S. Department of Labor.

2) The table above also shows that the program did not substantially increase the number of hours worked in one week. Sixty-one percent of the employees worked only part time.

3) Sixty-five percent of the TJTC jobs and subsequent jobs offered no fringe benefits. This is a slight improvement from jobs held before TJTC of which 79 percent offered no benefits. The auditors found that, aside from on-the-job training and orientation offered to all new hires, employers offered very little formal skills training, vocational education or higher education training.

[9] General Accounting Office, *Targeted Jobs Tax Credit*, February 1991, pg. 25.

4) In general, TJTC jobs required no special qualifications or skills. The large majority of the jobs consisted of cashiers/checkers, grocery clerks, nurse aides, fry cooks, food cashiers/order takers, waiters/waitresses, and janitorial housekeepers. Overall, the audit concluded that "TJTC employment mirrored other low-paying, low-skilled positions in the employee's work history... *[the]* data regarding jobs on which tax credits are being allowed cause us to question the value of the program."

5) In comparing retention periods between TJTC workers and a similar group from the general labor force, it was found that TJTC workers remained with their employer longer although turnover rates for both groups were high. After five quarters, 76 percent of TJTC workers had left their employers compared to 84 percent from the general work force.

In conclusion, the IG's audit recommended that the program be discontinued after its expiration on December 31, 1994. The report states:

> We do not believe the program has met *[its]* objective...we believe target group members were hired because there was a match between the employers' needs for inexpensive labor in high-turnover occupations, and willing individuals -- who are often members of the target groups -- to work for low wages in jobs which require little education or skill.

Will the WWTC Work?

Several studies concurred with the IG's findings. Linda Levine, a specialist in labor economics at the Congressional Research Service, concluded in her review of the TJTC program that:

> The TJTC cannot be considered a success in light of most studies' findings. The program helped relatively few members of its eligible population get jobs. Moreover, TJTC-eligibles typically were employed in subsidized jobs of short duration, which could not have afforded them much chance to acquire the skills and experience that might qualify them for unsubsidized jobs.[10]

Former Secretary of Labor, Robert Reich, referred to another study in a speech before the Center for National Policy in 1994:

> ...according to recent studies by Cornell University's John Bishop and Grinnel [sic] College's Mark Montgomery, at least 70% of these workers would have been hired even without their employers receiving a tax break...Investing scarce resources in programs that don't deliver cheats workers who require results and taxpayers who finance failure.[11]

---

[10] Congressional Research Service, *The Targeted Jobs Tax Credit, 1978-1994*, September 1995, pg. 21.

[11] *Op. Cit., Targeted Jobs Tax Credit Program: Employment Inducement or Employer Windfall?,* pg. 3.

Differences Between the WWTC and the TJTC

Why would the Administration put forth a proposal so similar to a program which was deemed a failure? According to Gene Sperling, Director of the National Economic Council, the WWTC was designed to account for the shortcomings of earlier versions of the plan. There are four main differences between the WWTC and its predecessor:

1) The tax credit is enhanced. Employers can claim 50 percent of the first $10,000 of wages per year for two years, as opposed to the TJTC which allowed 40 percent of the first $6,000 of wages to be claimed for only one year.

2) The definition of "qualified" wages is expanded. Under TJTC, qualified wages included wages paid to an employee for job-related services rendered. The WWTC treats the employer's cost of education and training assistance, health care and dependent care as qualified wages.

3) Long-term welfare recipients and their families are targeted. Eligible participants must receive welfare assistance for at least 18 months, while the TJTC's requirement was only 90 days.

4) The minimum retention period is longer. Employers could claim the TJTC after a worker was employed for at least 90 days, or 120 hours. The WOTC increased the minimum retention period to 180 days or 400 hours.

Financial Incentives

A fundamental problem with the TJTC program was its failure to change employers' hiring decisions. The WWTC seeks to correct this shortcoming by providing "powerful new, private-sector financial incentives" for businesses to hire targeted individuals.[12] However, the nature of subsidized employment, and the greater risk associated with hiring long-term welfare recipients, greatly lowers the enhanced incentives in the WWTC. Consequently, it is very unlikely that the WWTC will yield more successful results.

The increase in the maximum amount of the tax credit should provide greater incentives for businesses to hire welfare recipients. However, the larger size of the tax credit may only offset the higher potential risk an employer faces when hiring an individual who has received assistance for 18 months instead of 90 days. The longer individuals remain on welfare, the more likely they are to lose basic skills compared to other employees. The tax credit *must* be larger under the WWTC to compensate for the possibility of hiring a less productive worker. The net effect on incentives is at least partially neutralized.[13]

---

[12] *Budget of the United States,* Fiscal Year 1998, pg. 106.

[13] The value of the credit is also lowered because tax deductions for wages must be reduced by the amount of the credit.

Furthermore, data from the IG's audit suggest that the maximum amount of the credit will not be available to most firms. If WWTC jobs resemble TJTC jobs, which they likely will, then the average employee will work part time at or near the minimum wage. Even with higher minimum wage laws, the average worker will earn less than $10,000 annually preventing the employer from claiming the maximum credit.

Including the cost of education assistance, health care and dependent care as qualified wages can increase the size of the credit for employers who pay their WWTC workers less than $10,000 annually. However, the majority of subsidized jobs do not offer these types of fringe benefits. The IG's audit showed that 65 percent of TJTC employers did not offer any fringe benefits, and educational assistance was largely limited to on-the-job training and orientation. To the extent that subsidized jobs do not offer benefits, the inclusion of such costs in the definition of qualified wages will not have a significant impact on the amount of the credit employers can claim. As a result, the value of the credit is lowered, thereby reducing the associated incentives.

By extending the credit's availability to two years, the Administration means to further increase employers' financial incentives. However, the short duration of most subsidized jobs will not allow employers to take full advantage of the credit in the second year. The IG's audit found that only 24 percent of TJTC workers remained with their employer for five quarters. If the same statistic holds for WWTC employment, the availability of the credit in the second year will be largely irrelevant. In fact, the TJTC was also available for two years when the program was originally enacted, but the passage of the Tax Reform Act of 1986 eliminated the credit in the second year.

Finally, increasing the minimum retention period under WOTC will reduce churning. Churning occurs when employers manipulate turnover rates to maximize their tax credit by hiring several workers for short periods of time. With rapid turnover, employees do not have time to acquire the skills and experience they need to obtain unsubsidized jobs. However, the benefit must be weighed against the cost. Requiring employers to retain workers for longer periods of time may discourage them from hiring high-risk employees altogether.

Nonetheless, Rahm Emanuel, a senior adviser to President Clinton, insists the tax credit will be more effective than earlier plans because it is "just one piece of an overall strategy to make work more attractive than welfare."[14] Other pieces of the strategy include child care, higher minimum wages, health insurance for people leaving welfare, and transportation to get people to their jobs. The proposed "Welfare-to-Work Jobs Initiative" is also expected to facilitate the transition. This initiative would provide states with $3 billion of funding over three years (to be financed through the elimination of corporate subsidies) for job placement and job creation. States would be given flexibility to use the funds in innovative ways to design welfare reform plans suited to their particular needs.

Making "work more attractive than welfare" is an important component of welfare reform. However, while such initiatives may make welfare recipients more willing to work, they do not make businesses more willing to hire them. Thus, the Welfare-to-Work Jobs Initiative does nothing to improve the effectiveness of the proposed tax credit.

[14] *The New York Times*, "Clinton Will Seek Tax Credit for Hiring Welfare Recipients," January 28, 1997.

Overcoming the Stigma

A study by Gary Burtless, an economist at the Brookings Institution, found that employers often stigmatize job-seekers who were covered by a government subsidy. He noted that "People got fewer job offers if they mentioned to employers that they were covered by this tax subsidy. The result was exactly reverse of what we anticipated."[15] Former Secretary of Labor Robert Reich stated, "What worries me about tax credits to induce employers to hire people off welfare is that they may become a sort of stigma. It's like a scarlet letter - a sign to employers that this person could not otherwise get a job."[16]

To many employers, the financial incentive is not enough to compensate for the risk of hiring a potentially unproductive employee. This sentiment was expressed by Earl Graves, publisher of *Black Enterprise* magazine, when he told President Clinton at a recent roundtable discussion that it was unfair to expect businesses to "...sacrifice profit margins in order to do the government's job...It is my job to focus on the bottom line...Our elected officials cannot and should not give false hope to people, leading them to believe that businesses will hire them for jobs which require skills they do not have."[17]

Potential Costs of the WWTC

It is unlikely that the differences between the WWTC and the TJTC will be sufficient to address the problems which occurred under the TJTC program. Furthermore, targeted tax incentives, such as the WWTC, may create several harmful side effects.

Displacement and Perverse Incentive Effects

Targeted tax policies are often zero-sum games where one individual's gain is someone else's loss. Linda Levine noted that because of windfalls and substitution, a targeted tax credit may create no new jobs, "Instead, the same number of jobs are redistributed among different groups of people."[18] This occurs because employers do not create new jobs for program participants; they simply replace ineligible workers with eligible workers.

Under the WWTC, long-term welfare recipients may find jobs at the expense of other needy individuals who are not members of the eligible population. In effect, welfare recipients will have an advantage over others who are competing for entry level positions -- many of whom may be prior recipients of public assistance who do not qualify for the program, and who are struggling to stay off welfare. Such competition creates perverse incentive effects. Individuals may go on welfare, or stay on it longer than they otherwise would have, in order to qualify for the program.

---

[15] *Ibid.*

[16] *Ibid.*

[17] *Washington Post*, "Clinton Welfare Outreach Nets an Earful," February 19,1997.

[18] *Op. Cit., The Targeted Jobs Tax Credit, 1978-1994*, pg. 20.

Inefficiency

Using tax incentives to manipulate the labor market reduces economic efficiency. By subsidizing the wages of low-skilled workers, the WWTC will make low-skilled labor relatively less expensive than other productive inputs. If the WWTC achieves its goal, employers will substitute away from high-skilled labor and capital towards low-skilled labor. In the long run, this displacement will lower overall productivity and detract from economic growth.

A more efficient solution would be the institution of more broad-based tax incentives which would boost economic growth. This would provide businesses with growth opportunities so they can *create* new jobs for welfare recipients without sacrificing productivity or displacing other needy workers.

Special Interest Powers

Targeted tax incentives inevitably create loopholes which businesses seek to exploit. Consequently, some of the biggest proponents of an employment tax credit are not the job-seekers, but the employers and consultants who may receive windfalls. *The New York Times* reported that the TJTC program "...spawned an entire industry of personnel consultants who did the paperwork necessary to get the tax credit for employers. These companies became potent lobbyists for the tax credit."[19] Since its inception in 1978, the TJTC lapsed three times before its final expiration at the end of 1994. Each time the program lapsed, businesses and consultants successfully lobbied to renew the tax credit. The WWTC is subject to the same abuses and special interest pressures that occurred under the TJTC program.

Conclusion

The Administration's proposal for a Welfare-to-Work Tax Credit has not adequately addressed the problems which plagued its predecessor program, the Targeted Jobs Tax Credit. As a result, it is unlikely that the program will efficiently achieve its goal of providing new job opportunities for long-term welfare recipients. In particular, it is not clear that the proposed tax credit will provide stronger incentives to persuade employers to hire long-term welfare recipients.

Historically, subsidized jobs have been part-time, low-paying, low-skilled, short-term positions which do not substantially improve the employee's standard of living or long-term job prospects. Therefore, it is questionable whether employment tax credits are an effective use of taxpayers' dollars.

A more efficient plan would provide broad-based tax incentives to boost economic growth and stimulate job creation. Expanding unsuccessful government programs is not the solution to the welfare-to-work challenge.

Shahira ElBogdady
Research Analyst

[19] *The New York Times*, "Clinton Will Seek Tax Credits for Hiring Welfare Recipients," January 27, 1997.